

Internal Revenue Service  
TEGE Appeals Division  
1352 Marrows Rd  
Newark, DE 19711

CERTIFIED

Department of the Treasury

Date: **AUG 05 2008**

UIL Code: 501.03-00  
501.33-00

Number: 200908051  
Release Date: 2/20/2009

Taxpayer Identification Number:

**E**

Person to Contact:

A

Employee ID Number:

B

Tel:

Fax:

Refer Reply to:

AP:

In Re:

Exempt status

Tax Years: and subsequent  
years

Last Day to File a Petition with the  
United States Tax Court:

Dear :

This is a final adverse determination as to your exempt status under section 501(a) as an organization described under section 501(c)(3) of the Internal Revenue Code. Our adverse determination was made for the following reason(s):

You did not establish that you were operated exclusively for exempt purposes as required by section 501(c)(3) of the Internal Revenue Code. You have not established that your income did not inure to the benefit of individuals and shareholders, which is prohibited by Internal Revenue Code section 501(c)(3). You are operated for a substantial private purpose, which is prohibited by Internal Revenue Code section 501(c)(3).

In the alternative, you did not establish that you are an organization as described in section 509(a)(3) of the Internal Revenue Code. You have not established that you meet the organizational and operational requirements to be a section 509(a)(3) charity. You also have not established that you have the requisite relationships with one or more publicly supported organizations and that you are not controlled by disqualified persons.

Contributions to your organization are not deductible under Code § 170. You are required to file federal Form 1120 for the year(s) shown above.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed before the 91<sup>st</sup> (ninety-first) day after the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

You also have the right to contact the Office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call 1-877-777-4778, and ask for Taxpayer Advocate assistance.

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals procedures, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, or extend the time fixed by law that you have to file a petition in the United States Tax Court. The Taxpayer Advocate, can however, see that a tax matter, that may not have been resolved through normal channels, gets prompt and proper handling.

We will notify the appropriate State officials of this final adverse determination of your exempt status, as required by Code section 6104(c).

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Charles F. Fisher  
Appeals Team Manager

cc:

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Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX and 12/31/20XX

**LEGEND**

ORG = Organization name      XX = Date      City = city      XYZ = State  
 Founder family = founder family      Bm-1, Bm-2, BM3 & BM-4 = 1<sup>ST</sup>, 2<sup>ND</sup>, 3<sup>RD</sup> & 4<sup>TH</sup>  
 Board members,      EMP-1 = employee      CO-1, CO-2, CO-3, CO-4, CO-5, CO-6,  
 CO-7 & CO-8 = 1<sup>ST</sup>, 2<sup>ND</sup>, 3<sup>RD</sup>, 4<sup>TH</sup>, 5<sup>TH</sup>, 6<sup>TH</sup>, 7<sup>TH</sup> & 8<sup>TH</sup> COMPANIES.

**PRIMARY ISSUE:** Should the IRC § 501(c)(3) tax exempt status of ORG be revoked because it is not operated exclusively for tax exempt purposes?

**FACTS:**

**Organizing Document**

ORG (the "Organization") was created with a Declaration of Trust by BM-1 and BM-2, (each being a "Founder") and BM-1, ("Trustee") on January 1, 19XX. The Trust was created for the purpose of establishing an organization which is described in IRC § 501(c)(3) and IRC § 509(a)(3). The Trust Instrument provides that the Founder renounces any power to determine or control, by alteration, amendment, revocation, termination or otherwise, the income or principal of the Trust estate. In addition, the Trust Instrument also provides that the Founder renounces any interest, either vested or contingent, including any reversionary interest or possibility of reverter, in the income or principal of the Trust estate.

The Declaration of Trust further provides that each year the Trustee shall distribute 35% of the adjusted net income of the Trust to the CO-1, the named Primary Charity. In addition to this distribution, each year the Trustee shall distribute a total of 50% of the adjusted net income to one or more organizations listed on Schedule A.

There are 17 organizations listed on Schedule A and some of them state "and affiliated organizations", such as "CO-2 and affiliated organizations".

The Declaration of Trust provides that the Board shall be the governing body of the Trust and that the members of the Board shall be determined as follows:

- One Board member shall be appointed by the CO-1 or its designated agent
- Two Board members shall be from the class consisting of BM-1 and BM-2 and their descendants (the Founders Family)
- The other members of the Board shall be appointed by a majority vote of the board. The initial remaining Board members shall be BM-3 and BM-4.

On January 1, 20XX, the Declaration of Trust was amended to provide that references to CO-1 are deleted and substitute CO-3.

The Trust Document provides that upon winding up and dissolution of the Trust, the assets shall be distributed to a non-profit fund, foundation or corporation, which is organized and operated

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exclusively for charitable, educational, religious, and/or scientific purposes and which has established its tax exempt status under section 501(c)(3).

The Trust Document also states that in the event that the Trust does not obtain tax exempt status under Sections 501(c)(3) and 509(a)(3) of the Code, the assets of the Trust shall go to the Founder Family, as a contingent remainder.

By letter dated June 18, 19XX, the Organization was recognized by the Service as exempt from Federal income tax under section 501(a) because it is described in section 501(c)(3) and classified as an organization that is not a private foundation because it is described in section 509(a)(3).

The foundation reported that it held no meetings since formation.

#### Income and contributions

The following income and expenses were reported on Form 990.

	20XX	20XX	20XX	20XX
<b>Income</b>				
interest				
contributions				
<b>Total</b>				
<b>Charitable distributions</b>				
CO-3				
CO-2				
CO-4				
CO-5				
<b>Total</b>				

#### Loans

On January 1, 19XX, the organization made a loan of \$ to BM-1 and BM-2 and BM-3 and EMP-1. BM-1 and BM-2 and BM-3 are board members. BM-3 is an individual who has invested with BM-1 in several real estate ventures. BM-1 and BM-3 are members of CO-6. This loan provides for interest at the rate of 8.5 per cent per year and principal to be repaid on the first of each month. It calls for monthly payments of \$. The note states that any remaining indebtedness, if not sooner paid, shall be due and payable on January 1, 20XX.

BM-1 said stated that this is a 25 year amortization with a balloon payment due on January 1,

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20XX, which he stated is a common feature of income property loans.

The prime rate in January, 19XX when the loan was made was 8.25%. According to Revenue Ruling 99-8, the long term applicable federal rate was 5.24%.

Based on a review of bank deposits, this loan is not being repaid on a regular basis. It appears that several months go by without any payments and there are no penalties for late paying of the loan. In the year 20XX, five months went by with no payments made on the loan and then a large payment was made to "catch up". In the year 20XX, only two payments were made and the total payments on the loan for the year were \$, instead of the \$ called for by the payment schedule.

Two additional loans were made by the ORG. The promissory notes were provided. One was dated June 12, 20XX for \$ and one was dated May 22, 20XX for \$. Both of these promissory notes provide for an interest rate of 8% per annum. They both state "All accrued but unpaid interest hereon and the principal amount hereof shall be due and payable upon the earlier to occur of (i) sale of the real property described in Exhibit "A" attached hereto, or (ii) December 31, 20XX. The maker of these promissory notes is CO-6, and the notes were signed by BM-1. No payments were made on these notes in 20XX. In 20XX, \$ was repaid and \$ was borrowed.

#### **Minutes**

The organization has minutes of the first meeting of the board held on January 1, 19XX. These minutes tell how the trust will operate.

Item 12 says that "this Trust need not have any employees in the sense that no one will be carried on a payroll as such. That is to say, that this Trust need not withhold State or Federal income taxes or Social Security taxes. All its executives, agents or other employees, will be remunerated as consultants, receiving consultant fees on a contract basis, and any and all remuneration paid to them will be reported by this Trust at the year end on IRS Form 1099."

No other meetings were held, according to BM-1.

#### **LAW:**

IRC § 501(c)(3) exempts from Federal income tax: corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation and which does not participate in, or intervene in

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(including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Regulation section 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Regulation section 1.501(c)(3)-1(c)(2) provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. The words "private shareholder or individual" refer to persons having a personal and private interest in the activities of the organization.

Regulation section 1.501(c)(3)-1(d)(1)(ii) provides an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

In Revenue Ruling 67-5, 1967-1 C.B. 123, it was held that a foundation controlled by the creator's family was operated to enable the creator and his family to engage in financial activities which were beneficial to them, but detrimental to the foundation. It was further held that the foundation was operated for a substantial non-exempt purpose and served the private interests of the creator and his family. Therefore, the foundation was not entitled to exemption from Federal income tax under section 501(c)(3).

In Better Business Bureau v. United States, 326 U.S. 279 (1945), the United States Supreme Court held that regardless of the number of truly exempt purposes, the presence of a single substantial non-exempt purpose will preclude exemption under section 501(c)(3).

In Founding Church of Scientology v. U.S., 412 F. 2d 1197 (Ct. Cl. 1969) the court stated that loans to an organization's founder or substantial contributor can constitute inurement that is prohibited under section 501(c)(3). In that case, the church made loans to its founder and his family and failed to produce documentation that demonstrated that the loans were advantageous to the church. The church also failed to produce documentation to show that the loans were repaid. Significantly, the court stated that "the very existence of private source of loan credit from an organization's earnings may itself amount to inurement of benefit."

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Facts that show a charity's investments that are decided in part by the needs of private interests indicate the charity may not be operated exclusively for exempt purposes. Western Catholic Church v. Commissioner, 73 T.C. 196, 214 (1979).

The very presence of a private source of loan credit may amount to inurement. Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969); Church in Boston v. Commissioner, 71 T.C. 102 (1978).

Loans to disqualified persons promote private rather than charitable purposes. Best Lock Corporation v. Commissioner, 31 T.C. 1217, 1235-37 (1959).

#### GOVERNMENT'S POSITION:

The IRC § 501(c)(3) tax exempt status of ORG (the "Organization") should be revoked because it is not operated exclusively for tax exempt charitable purposes. More than an insubstantial purpose of the organization is to serve the financial needs of its founder, BM-1. Additionally, the net earnings of the Organization have inured to the benefit of insiders.

As a substantial contributor, BM-1 is a disqualified person and an insider. He has operated the Organization for the benefit of his business interests. There is no indication that the terms of the loans to him or his businesses were considered by the entire board, that alternative investments for the Foundation were considered, or that the Promissory Notes were reviewed by anyone acting in the interests of charity.

It does not appear that any attempt is made to ensure the Foundation's assets or income are protected. The Foundation made two loans where no repayments are required until 20XX.

Additionally, the loans to BM-1 are the largest asset of the Foundation.

There is no evidence that any of the supported organizations are attentive to the operations of the Foundation. There is no indication that any alternative investments were considered. There is no assurance that the Foundation made any attempts at collection, although the loan for which monthly payment was required was not current on payments. There is no attempt by the board to ensure that the Foundation received the income due it. There is no indication that any of the supported organizations tried to ensure that the supported organizations received the correct amount of the Foundation's income.

Although the organization had no employees, the only minutes of the organization suggest that it planned to intentionally treat them incorrectly if it ever had employees.

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The Organization is controlled by BM-1. Only one meeting has been held and most of the assets of the Foundation are receivables from business interests of BM-1.

	20XX	20XX	20XX	20XX
Loaned to Founder or the LLC				
Total assets				
Loans as a percent of assets				
Charitable gifts as a percent of assets				

\*At the end of 20XX, the organization wrote a check to the CO-3 for more than the balance in the checking account, resulting in a negative number for cash. This is why the loans are more than 100 percent of assets.

The Organization, which is controlled by BM-1, is operated to enable BM-1 to engage in financial activities which are beneficial to him and/or entities with whom he is transacting business, but detrimental to the Organization. Accordingly, it is operated for a substantial non-exempt purpose. See Revenue Ruling 67-5.

The facts show that BM-1 is able to use the Foundation's funds as if they were his own, borrowing from the Foundation and repaying without observing the terms of the note he signed.

The Organization's net earnings have inured to the benefit of insiders.

Inurement can take the form of questionable transactions that have no causal relationship to the organization's exempt purposes but result in some benefit to an insider, whether or not the insider provides goods and services of commensurate value to the entity. The insider is in a position to exercise control over the organization's net earnings as if they were his/her own by using them at will rather than within limitations of an employer-employee or fiduciary capacity. In effect, the insider is using the public's "net earnings" for his/her own benefit.

Accordingly, the Organization's status as an organization described under section 501(c)(3) should be revoked, effective January 1, 20XX, because it did not operate exclusively for exempt purposes because its assets inured to, and it served the private interests of, its creators.

**ALTERNATIVE ISSUE # 1:** Should ORG be reclassified as a private foundation?

#### **FACTS:**

The facts concerning the organizing document of the Foundation and the loans made by the Foundation are described above.



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The organization made contributions to CO-4 and CO-5 in 20XX. The organization made a contribution to CO-5 in 20XX.

The organization does not conduct any independent charitable activities.

The trust document provides that the organization is a type 3, operated in connection with, supporting organization. The trust document has been amended to provide that the supported organization is the CO-3.

In 20XX, the organization had income of \$ , all interest on loans to CO-6. It made contributions of \$. Of this, \$ or 69% was given to the CO-2, and \$ or 27.6% was given to the CO-3. That is, the endorsement area of the checks shows that they were deposited to the account of CO-3. The thank you receipt provided by the organization gives the EIN of the CO-3 in City, XYZ. It also contributed \$ to CO-5 and \$ to CO-4. CO-4 is not listed on the Schedule A of the organizing document as a supported organization.

In 20XX, the organization had income of only \$, again all interest on loans. It again contributed \$ to CO-5, and it gave \$ to the CO-2. On December 31, 20XX, when the checkbook showed a balance of \$, it wrote a check to the CO-3 for \$.

The organization provided a thank you note from the president of the CO-7, where it states, "It is my understanding that our chapter is a non-profit, tax-exempt corporation as described in Section 501(c)(3)." No evidence has been shown that the CO-7 or the CO-5 have been recognized by the Internal Revenue Service as described in 501(c)(3).

#### LAW:

Income Tax Regulations section 1.509(a)-4(c) regarding the organizational test a 509(a)(3) organization must meet provides:

(1) *In general.* —An organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in §1.501(c)(3)-1(b)(2)):

- (i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);
- (ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;

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- (iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and
- (iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

Income Tax Regulations section 1.509(a)-4(e) regarding the operational test a 509(a)(3) organization must meet provides:

(1) *Permissible beneficiaries.* — A supporting organization will be regarded as “operated exclusively” to support one or more specified publicly supported organizations (hereinafter referred to as the “operational test”) only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by a specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to an individual rather than to an organization the same standard shall be applied as in §53.4945-4(a)(4) of this chapter. Similarly, an organization will be regarded as “operated exclusively” to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which is described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

(2) *Permissible activities.* — A supporting organization is not required to pay over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph. The supporting organization may also engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

Income Tax Regulations section 1.509(a)-4(f) regarding the nature of relationships required for section 509(a)(3) organizations provides:

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(1) *In general.* — Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).

(2) *Types of relationships.* — Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met in order to meet the requirements of subparagraph (1) of this paragraph. Thus, a supporting organization may be:

- (i) Operated, supervised, or controlled by,
- (ii) Supervised or controlled in connection with, or
- (iii) Operated in connection with, one or more publicly supported organizations.

(3) *Requirements of relationships.* — Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3)(B) must insure that:

- (i) The supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and
- (ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

(4) *General description of relationships.* — In the case of supporting organizations which are "operated, supervised, or controlled by" one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of supporting organizations which are "supervised or controlled in connection with" one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization which is "operated in connection with" one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.

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Income Tax Regulations section 1.509(a)-4(i) provides guidance on the meaning of "operated in connection with" as follows:

(1) *General rule*

(i) Except as provided in subdivisions (ii) and (iii) of this subparagraph and subparagraph (4) of this paragraph, a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" which is defined in subparagraph (2) of this paragraph and the "integral part test" which is defined in subparagraph (3) of this paragraph.

(2) *Responsiveness test*

(i) For purposes of this paragraph, a supporting organization will be considered to meet the "responsiveness test" if the organization is responsive to the needs or demands of the publicly supported organizations within the meaning of this subparagraph. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii)

(a) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

(b) One or more members of the governing bodies of the publicly supported organizations are also officers, directors or trustees of, or hold other important offices in, the supporting organizations; or

(c) The officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors or trustees of the publicly supported organizations; and

(d) By reason of (a), (b), or (c) of this subdivision, the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization.

(iii)

(a) The supporting organization is a charitable trust under State law;

(b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and

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(c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.

(3) *Integral part test; general rule*

(i) For purposes of this paragraph, a supporting organization will be considered to meet the "integral part test" if it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii) The activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.

(iii)

(a) The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization. In addition, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement of this subdivision with respect to such supporting organization. Except as provided in (b) of this subdivision, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness. In applying the preceding sentence, if such supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the department or school shall be substituted for the total support of the beneficiary organization.

(b) Even where the amount of support received by a publicly supported beneficiary organization does not represent a sufficient part of the beneficiary organization's total support, the amount of support received from a supporting organization may be sufficient to meet the requirements of this subdivision if it can be demonstrated that in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. This may be the case where either the supporting organization or the beneficiary organization earmarks

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the support received from the supporting organization for a particular program or activity, even if such program or activity is not the beneficiary organization's primary program or activity so long as such program or activity is a substantial one.

....

(d) All pertinent factors, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and supporting organization and the purpose to which the funds are put (as illustrated by subdivision (iii)(b) and (c) of this subparagraph), will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization. Normally the attentiveness of a beneficiary organization is motivated by reason of the amounts received from the supporting organization. Thus, the more substantial the amount involved, in terms of a percentage of the publicly supported organization's total support the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance. An example of acceptable evidence of actual attentiveness is the imposition of a requirement that the supporting organization furnish reports at least annually for taxable years beginning after December 31, 1971, to the beneficiary organization to assist such beneficiary organization in insuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return (taking appreciation into account) and has not engaged in any activity which would give rise to liability for a tax imposed under sections 4941, 4943, 4944, or 4945 if such organization were a private foundation. The imposition of such requirement within 120 days after October 16, 1972, will be deemed to have retroactive effect to January 1, 1970, for purposes of determining whether a supporting organization has met the requirements of this subdivision for its first two taxable years beginning after December 31, 1969. The imposition of such requirement is, however, merely one of the factors in determining whether a supporting organization is complying with this subdivision and the absence of such requirement will not preclude an organization from classification as a supporting organization based on other factors.

(e) However, where none of the beneficiary organizations is dependent upon the supporting organization for a sufficient amount of the beneficiary organization's

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support within the meaning of this subdivision, the requirements of this subparagraph will not be satisfied, even though such beneficiary organizations have enforceable rights against such organization under State law.

Rev. Rul. 76-208, 1976-1 C.B. 161, held that a charitable trust described in section 501(c)(3) did not satisfy the "substantially all" requirement of the integral part test set forth in section 1.509(a)-4(i)(3)(iii)(A) of the regulations and was therefore not a supporting organization. The trust instrument provided that 75 percent of the trust income was to be distributed annually to a specified church with the remaining 25 percent to accumulate until the original corpus doubled, at which time the entire annual income was to be distributed to the church. The Service also stated that for purposes of the integral part test, the term "substantially all" means 85 percent or more.

Income Tax Regulations section 1.509(a)-4(j) regarding control by disqualified persons provides:

- (1) *In general.* —Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered "controlled", for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has

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a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

### GOVERNMENT'S POSITION:

As set forth above, it is the government's primary position that the tax exempt status of ORG (the "Organization") should be revoked. Alternatively, the Organization should be reclassified as a private foundation.

Due to Congressional concerns about wide-spread abuses of their tax-exempt status by private foundations, private foundations were defined and subjected to significant regulations and controls by the Tax Reform Act of 19XX. The definition of a private foundation is intentionally inclusive so that all organizations exempted from tax by IRC § 501(c)(3) are private foundations except for those specified in IRC § 509(a)(1) through(4). Roe Foundation Charitable Trust v. Commissioner, T.C. Memo. 1989-566; Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274, 1277 (7<sup>th</sup> Cir. 1979). The Organization claims it is excepted from private foundation status and not subject to the rules of Chapter 42 applicable to private foundations because it meets the requirements of section 509(a)(3), which defines supporting organizations.

Public charities (organizations described in section 501(c)(3) that meet the requirement of sections 509(a)(1) or (2)) are excepted from private foundation status on the theory that their exposure to public scrutiny and their dependence on public support keep them from the abuses to which private foundations are subject. Supporting organizations are similarly excepted from private foundation status. Supporting organizations are excepted on the theory that the public charities that they support, rather than the public, will provide the scrutiny to keep supporting organizations from the types of abuses to which private foundations are prone. Quarrie, 603 F.2d at 1277-78.

Section 509(a)(3) organizations must meet all three of the following tests:

- 1) Organizational and Operational Tests under section 509(a)(3)(A).
- 2) Relationship Test under section 509(a)(3)(B).
- 3) Disqualified Person Control Test under section 509(a)(3)(C).



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Overall, these tests are meant to ensure that a supporting organization is responsive to the needs of a public charity and intimately involved in its operations and that the public charity (or publicly supported organization) is motivated to be attentive to the operations of the supporting organization and that it is not controlled, directly or indirectly, by disqualified persons.

### Organizational and Operational Tests

The Organization is not organized to benefit one or more specified publicly supported organizations. Pursuant to Treas. Reg. § 1.509(a)-4(c)(1)(iii) and (iv), an organization's governing instrument must state the specified publicly supported organization(s) on whose behalf the organization is to be operated and cannot expressly empower the organization to support or benefit any organizations other than the specified publicly supported organization(s). The Organization's dissolution clause allows distributions to organizations other than the specified publicly supported organizations upon termination of the Organization. The possible beneficiaries are not limited to the CO-3 or to the organizations specified on Schedule A of the Organization's Declaration of Trust.

Therefore, the organizational test is not met. See Quarrie, supra (holding that the organizational test was not satisfied where the trustee had the power to substitute beneficiaries when, in the judgment of the trustee, the uses of the named beneficiaries became unnecessary, undesirable, impracticable, impossible or no longer adapted to the needs of the public).

Moreover, the operational test set forth in Treas. Reg. § 1.509(a)-4(e)(1) is not satisfied. A supporting organization will be regarded as "operated exclusively" to support a specified publicly supported organization(s) only if it engages in activities which support or benefit the specified publicly supported organizations(s). As was discussed under the Primary Issue above, the Organization apparently has served private interests and has made payments for the benefit of the business interests of BM-1. Therefore, it has not established that it operated exclusively for the benefit of the publicly supported organizations.

In addition, the operational test is not satisfied because the Organization made distributions to other organizations that were not specified in the original or the amended declaration of trust. These distributions are in violation of Treas. Reg. § 1.509(a)-4(e)(1). The ORG gave \$ to the CO-5 Club and \$ to CO-4 in 20XX and it gave \$ to the CO-5 Club in 20XX. Neither the CO-5 Club nor CO-4 is listed on the Schedule A of the trust document.

### Relationship Test

As set forth in Treas. Reg. § 1.509(a)-4(f)(2), there are three permissible relationships: (a) operated, supervised, or controlled by; (b) supervised or controlled in connection with; and (c) operated in connection with one or more publicly supported organizations.

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The relationships "operated, supervised or controlled by" and "supervised or controlled in connection with" presuppose a substantial degree of direction over the policies, programs and activities of the supporting organization by a publicly supported organization. The "operated, supervised or controlled by" relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity or the membership of the publicly supported organization. The "supervised or controlled in connection with" relationship is established by the fact that there is common supervision or control by the persons supervising or controlling both the supporting and the publicly supported organizations (i.e., that control or management of the supporting organization is vested in the same persons that control or manage the publicly supported organization).

In the present case, only one of the five members of the board is appointed by the supported organization. Thus, the organization must meet the "operated in connection with" test to qualify as a supporting organization.

In order to be a type three supporting organization, the organization must meet a responsiveness test and an integral part test.

In order to meet the responsiveness test, either Treas. Reg. § 1.509(a)-4(i)(2)(ii) or (iii) must be satisfied. Treas. Reg. § 1.509(a)-4(i)(2)(ii) requires that the board member appointed by the supported organization have a significant voice in the operations of the supporting organization. There were no minutes of board meetings from 20XX through 20XX. There are five members of the board; two are from the family, one is a business associate of the founder and one is appointed by the supported organization. In the absence of any board minutes, there is no indication that the board member appointed by the supported organization had a significant voice in the investment policies of the supported organization or in the timing of grants or the selection of recipients. See Roe Foundation Charitable Trust v. Commissioner, 58 T.C.M. 402 (1989).

Alternatively, the supporting organization must be a charitable trust under state law and each specified publicly supported organization must be a named beneficiary under the charitable trust's governing instrument and the beneficiary organization must have the power to enforce the trust and compel an accounting under state law. Treas. Reg. § 1.509(a)-4(i)(2)(iii). Section 2.2.1 of the Trust states that the trustee shall distribute 35% of the net income of this trust to the primary charity. Section 2.2.2 states, "a total of 50% of the net income shall be distributed to one or more of the organizations listed on Schedule A". There are seventeen organizations listed on Schedule A. Only one is entitled to receive a portion of the Organization's net income. The Organization is not required to make any payments to the other sixteen organizations. Therefore, the other sixteen specified publicly supported organizations cannot realistically be considered named beneficiaries because the Trust does not require the Trustees to make any distributions to

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these organizations and the organizations can not compel the Trustee to make distributions to them under state law.

Therefore, the Organization does not meet either of the "responsiveness" tests.

The organization must also satisfy the integral part test.

There are two ways to meet the integral part test. One is based on the nature of the activities the supporting organization engages in to support the supported organization. The alternate, the more complex test is based on the financial support the supporting organization provides the supported organization.

Except as provided in Reg. 1.509(a)-1(i)(3)(iii)(b), the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to ensure such attentiveness. Reg. 1.509(a)-4(i)(3)(iii)(a).

The regulations do not specify what percentage of a supported organization's support must be received from a supporting organization to meet the integral part test. The requirement is that facts and circumstances show that the support is sufficient to ensure that the supported organization is attentive to the operations of the supporting organization. Reg. 1.509(a)-4(i)(3)(iii). However, in one case Chief Counsel opined that less than 10 percent would be unlikely by itself to ensure attentiveness. G.C.M. 36379, dated August 15, 19XX.

The amounts that the ORG contributes to public charities are less than two percent of their annual incomes.

The 20XX income of the CO-3, whose EIN was on the thank you receipt was \$. The \$ contributed by the ORG represents less than one per cent of this. The 20XX income of CO-3, who endorsed the check of the organization, was \$. The \$ contributed by the ORG is also less than one per cent of this. The organization has stated that it supports the endowment fund of the CO-3 and supplied a brochure called '20XX, an annual report of the Local Endowment'. This is the first annual report of the Endowment. This reports that the endowment was valued at \$ at year end of 20XX. It reports new cash and in-kind contributions during 20XX were \$. \$ is 1.9 percent of \$. Additionally, the annual income of the CO-2 is not known, but \$ is not enough to ensure attentiveness to the organization by a large, world wide likely to have income of at least several million dollars.

The ORG claimed that its contribution to the CO-3 was earmarked for their golf tournament. This was a fundraising event for the CO-3, not a program activity. The total cost of the Golf Tournament was \$. The total income was \$, including \$ from the ORG. Without the contribution of the CO-8, the organization would have made \$ instead of \$. There is no

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evidence that the beneficiary organization, the CO-3, was attentive to the operations of the ORG in order to avoid interruption of the golf tournament. Further, the fact that the checks were not cashed for several months after they were written suggests the recipient was not attentive to the foundation.

#### **Disqualified Person Control Test**

As noted above, BM-1 is a disqualified person because he is a substantial contributor to the Foundation. There is no indication that any representatives of any of the organizations named in the Trust Document have any input to the operations of the Organization.

Additionally, there is no evidence that any of the supported organizations are attentive to the operations of the Foundation. There is no indication that any alternative investments were considered. There is no assurance that the Foundation will attempt to enforce collection should the loans become delinquent.

Accordingly, the Organization should be reclassified as a private foundation because it does not qualify as a supporting organization under the requirements set forth in Treas. Reg. § 1.509(a)-4(c) through (j).

**ALTERNATIVE ISSUE # 2:** If ORG is reclassified as a private foundation, whether it is liable for the tax on investments which jeopardize charitable purpose under IRC § 4944.

#### **FACTS:**

The largest assets of the organization are the notes and loans receivable from its founder and his business interests. Two loans have no scheduled repayments until 20XX.

	20XX	20XX	20XX	20XX
Loaned to Founder or The LLC				
Total assets				
Loans as a percent of assets				

\*At the end of 20XX, the organization wrote a check to the CO-3 for more than the balance in the checking account, resulting in a negative number for cash. This is why the loans are more than 100 percent of assets.

#### **LAW:**

IRC § 4944 imposes a tax on investments which jeopardize a private foundation's charitable purpose.

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Section 4944(a)(1) imposes a tax on the private foundation when the private foundation invests any amount in such a manner as to jeopardize the carrying on of any of its exempt purposes, which tax is equal to 5 percent of the amount so invested for each year (or part thereof) in the taxable period.

Section 4944(b)(1) imposes an additional 25 percent tax on the private foundation when the tax under section 4944(a)(1) is imposed on the private foundation for an investment and such investment is not removed from jeopardy within the taxable period.

Section 4944(e)(1) defines "taxable period," for purposes of this excise tax, as the period beginning with the date on which the amount is so invested and ending on the earliest of the date (A) of mailing a notice of deficiency with respect to the section 4944(a)(1) tax, (B) on which the tax under section 4944(a)(1) is assessed, or (C) on which the amount so invested is removed from jeopardy.

Section 4944(e)(2) provides that an investment which jeopardizes the carrying out of exempt purposes shall be considered to be removed from jeopardy when such investment is sold or otherwise disposed of, and the proceeds of such sale or other disposition are not investments which jeopardize the carrying out of exempt purposes.

Section 53.4944-1(a)(2) of the Treasury Regulations provides that, in general, an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In addition, the determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole.

IRC § 4946 contains certain definitions for purposes of section 4944 excise taxes.

Section 4946(b)(1) defines "foundation manager" as an officer, director or trustee of the foundation.

### **GOVERNMENT'S POSITION:**

If ORG (the "Organization") is held to be a private foundation, it is liable for the taxes on investments which jeopardize charitable purpose under IRC § 4944(a)(1) and (b)(1).

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Section 4944 imposes a tax on investments which jeopardize a private foundation's charitable purpose. Section 4944(a)(1) imposes a tax on the private foundation when it invests any amount in such a manner as to jeopardize the carrying on of its exempt purposes. In any case in which the section 4944(a)(1) tax is imposed, section 4944(b)(1) imposes a tax on the private foundation when the investment upon which the tax is imposed is not removed from jeopardy within the taxable period. Section 53.4944-1(a)(2) of the regulations provides that, in general, an investment is considered to jeopardize the carrying out of the exempt purposes of a private foundation when it is determined that the foundation managers, in making the investment, failed to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. Moreover, the regulation also requires that this determination shall be made on an investment by investment basis, in each case taking into consideration the foundation's portfolio as a whole.

Since BM-1 was the Trustee of the Organization at all relevant times, he qualifies as a foundation manager for section 4944 purposes. See IRC § 4946(b)(1). Almost all of the Organization's assets were loaned to the founder. It is clear that the foundation manager, in making the investment, failed to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the Organization. Accordingly, the Organization should be held liable for the private foundation taxes under section 4944(a)(1) and, if it fails to remove the investment from jeopardy within the taxable period, it should also be held liable for the tax under section 4944(b)(1).

#### CONCLUSION:

For the reasons set forth above, we have determined that ORG (the "Organization") is not an organization described in section 501(c)(3). Alternatively, the Organization should be reclassified as an organization that is a private foundation defined in section 509(a) and it should be held liable for the excise taxes under section 4944(a)(1) and (b)(1).

#### COMPUTATION OF JEOPARDIZING INVESTMENT TAX

	Code Section	Jeopardizing investment amount	Tax %	Tax
20XX	4944(a)(1)		5%	
20XX	4944(a)(1)		5%	